

# Finding Large Opportunity in Midcaps

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## In brief:

- Midcap stocks offer diversification benefits, greater selection opportunities and a structural return premium relative to large-cap stocks.
- Recent midcap underperformance has been driven by a steady decline in relative valuation, which is unlikely to persist indefinitely.
- Current relative midcap valuation levels may provide an attractive entry point.

Market capitalization has long been considered a significant factor in equity returns. Over the past century, smaller capitalization stocks outperformed larger stocks on average.<sup>1</sup> Fundamentally, smaller stocks tend to receive less investor attention than large caps, which may lead to relative underpricing, a delay in the incorporation of fundamental information into stock prices and the potential for higher returns.

Midcaps are a particularly interesting area of focus. These stocks have the potential to offer higher liquidity, superior quality and reduced risk compared to small-cap stocks while still providing exposure to the size premium. Furthermore, although the size premium in small caps is well documented, similar analysis of midcap stocks is less prevalent, which may allow for potentially greater investment opportunities.

## Exploring the Fundamental Advantages of Midcaps

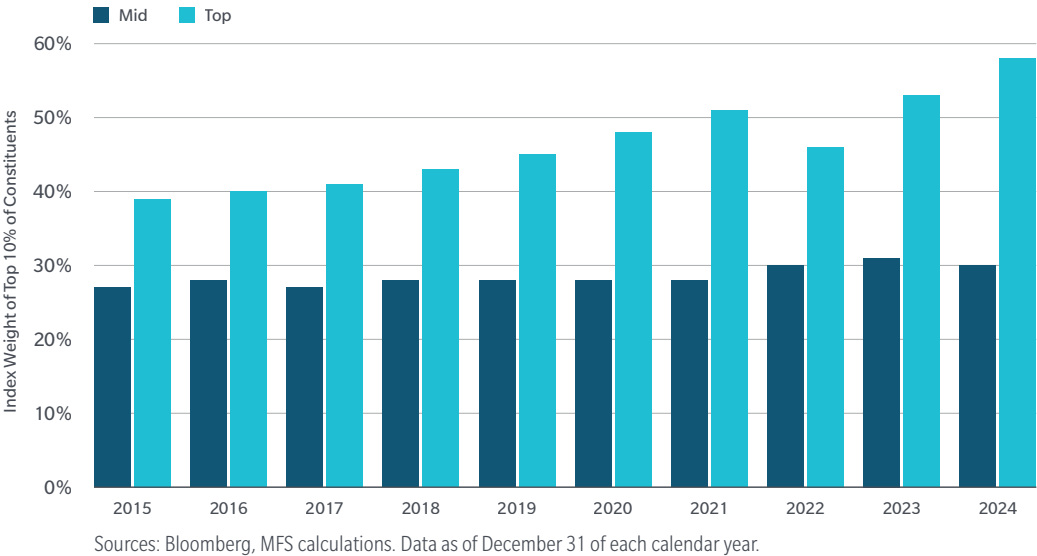
### Less Analyst Coverage

Midcaps receive less analyst coverage than their larger counterparts. The average analyst coverage for constituents of the Russell Midcap® Index (the "Mid") is slightly more than half of that for the Russell Top 200® (the "Top"), with 17 analysts on average compared to 31.<sup>2</sup> Moreover, a significant portion of midcap stocks — 17% — receive fewer than 10 analyst recommendations, whereas none of the Top stocks fall into this category. The lower attention paid to midcap stocks may allow the skilled investor greater opportunity for security selection alpha.

### Stock and Sector Concentration

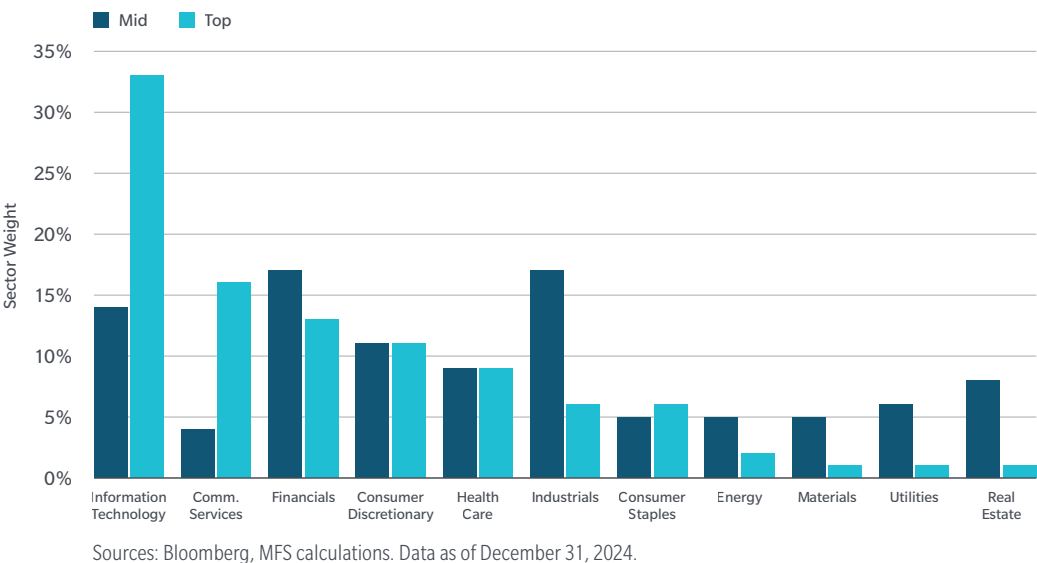
The Top index is quite top heavy (and has been getting heavier), introducing considerable idiosyncratic risk even in passive allocations. Exhibit 1 shows that the largest 10% of stocks (20 stocks) account for nearly 60% of the market capitalization of the Top index. In contrast, the top 10% of stocks (80 stocks) comprise under 30% of the Mid, greatly reducing the potential for unwanted issuer concentration.

Exhibit 1: Mid and Top Index Concentration



Elevated and potentially uncomfortable concentration in the Top index extends to the sector level as well. As illustrated in Exhibit 2, the Top index is significantly concentrated in technology, constituting roughly a third of its composition, while sectors like energy, materials, utilities and real estate each make up less than 5% of the index. In contrast, the Mid index features a more balanced sector distribution, with technology representing only about 14% of the index and more equitable allocations across the sectors where the Top index is underrepresented. A more balanced sector distribution may reduce the risk of overexposure to a single sector and foster more stable performance across varying economic cycles.

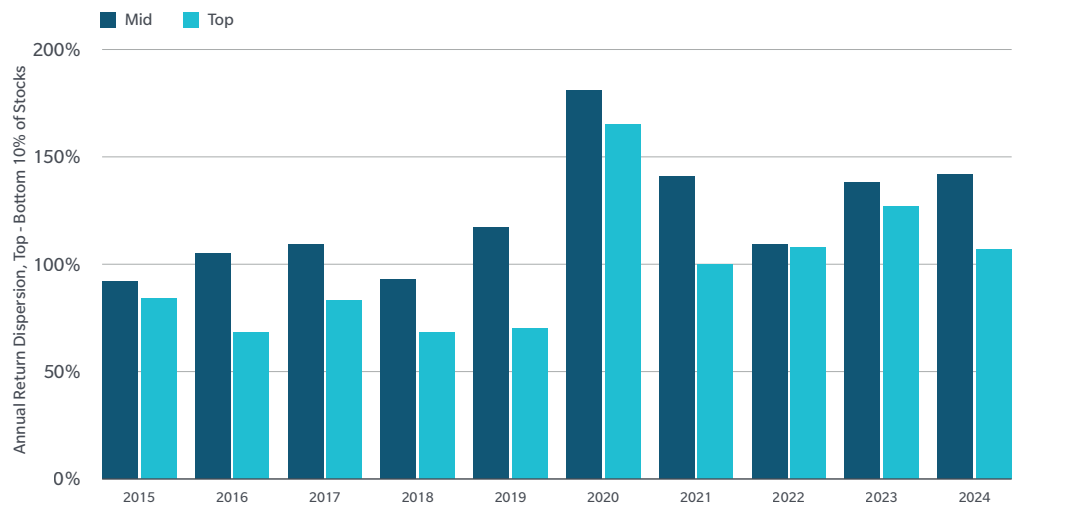
Exhibit 2: Mid and Top Sector Weights



Return Dispersion

Greater return variability among constituent stocks may increase the opportunity for a skilled active manager to outperform the index. Exhibit 3 shows that the Mid index has often exhibited greater return dispersion among constituents as compared to the Top index. Selecting the 10% best performing stocks in Mid has typically outperformed selecting the worst 10% by over 100 percentage points of annual return. In the Top index, this return dispersion across issuers has tended to be considerably lower, as can be seen in Exhibit 3. The higher return dispersion in Mid creates a tangible opportunity for stock selection.

Exhibit 3: Mid and Top Dispersion



**Graph notes:** Each bar shows the difference between the simple average of the annual returns of the top 10% and bottom 10% of stocks (sorted by returns) for each index as of December 31 of each year. Sources: Bloomberg, MFS calculations.

Exploring the Historical Size Premium

As demonstrated above, midcaps offer better selection opportunities, increased sector diversification and reduced issuer concentration risk, but do they also produce superior returns? Exhibit 4 shows statistics of midcap and Top performance from January 1979 through December 2024. Over the sample, midcaps outperformed by about 1% annualized. By virtue of their higher return, a strategy allocating to midcaps at the expense of Top would have generated a positive Sharpe ratio.

Exhibit 4: Historical Mid and Top Performance

| Annualized Return (Net of Cash) |       | Mid vs. Top        |       |
|---------------------------------|-------|--------------------|-------|
|                                 |       | Annualized Return  | 0.96% |
| MID                             | 9.44% | Standard Deviation | 7.12% |
| TOP                             | 8.47% | Sharpe Ratio       | 0.14  |

Sources: Bloomberg data from January 1979 through December 2024, MFS calculations.

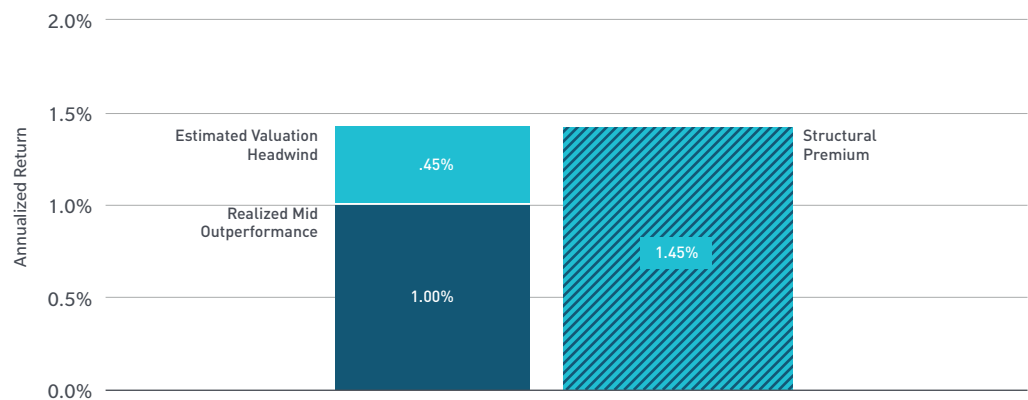
But a more nuanced comparison of relative returns can be made if we isolate the impact of changes in relative valuations. We can represent the relative outperformance of midcaps as the sum of two components:

Midcap Outperformance = Structural Premium + Changes in Relative Valuation

To assess the attractiveness of midcaps as an asset class, it is important to disentangle these two drivers of relative returns. A structural premium, to the extent it exists, is something we believe will persist, providing a compelling reason to invest in the asset class. Changes in relative valuation — for example, a continued cheapening of Mid relative to Top — can't persist in perpetuity and should not drive relative returns over the very long term.

For instance, from 1997 to 2024, Mid outperformed Top by an average of 100 basis points annually.<sup>3</sup> However, on average during this period, the relative valuation for midcaps (relative to Top) decreased by 45 basis points annually (as measured by price-to-book ratio).<sup>4</sup> Said another way, if the relative price-to-book ratios between midcaps and large caps had remained constant, the annualized outperformance of midcaps could have been 45 basis points higher, approaching 1.5% in total. This analysis increases conviction in the existence of a structural premium for midcaps and enhances our estimate of its magnitude, as shown in Exhibit 5. Importantly, and as we examine in the next section, the potential for future valuation corrections from today's levels could provide a further tailwind for midcap relative performance.

Exhibit 5: Structural Premium Decomposition

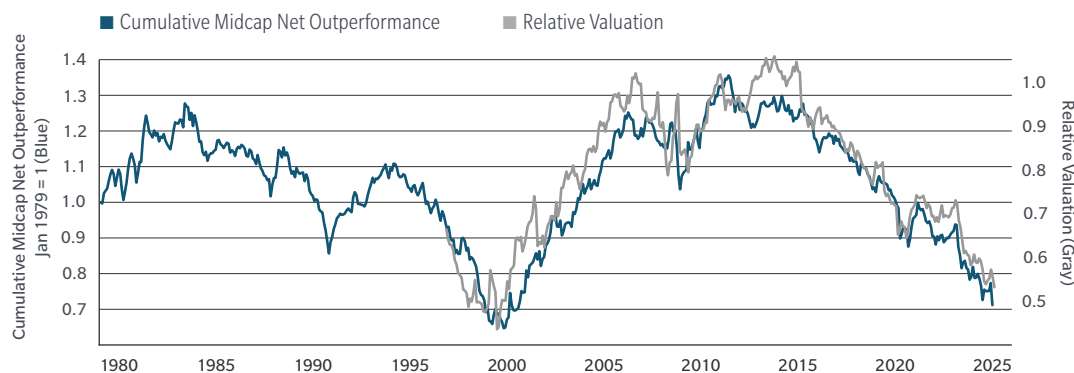


Sources: FactSet, MFS calculations. Data from December 1997 to December 2024.

Current Environment in Context of Historical Relative Valuations and Returns

It is instructive to examine the historical relationship between relative midcap performance and relative valuation (compared to Top). Exhibit 6 displays historical midcap net outperformance — where “net” subtracts the assumed 1.45% annualized structural premium — alongside the relative valuation. These two series track each other very closely: From 1997 to 2014, both net return and the valuation changes were positive, with similar annualized magnitudes of 2.4% and 3.1%, respectively. Conversely, from 2015 to 2024, both metrics turned sharply negative, closely aligning once more in magnitude at -5.3% and -4.9%, respectively. This evidence shows that relative valuations strongly influence the degree to which the midcap relative performance will exceed the assumed 1.45% structural premium.

Exhibit 6: Cumulative Midcap Net Outperformance and Relative Valuations



| ANNUALIZED METRICS                | 1997*–2014 | 2015–2024 |
|-----------------------------------|------------|-----------|
| Average Midcap Net Outperformance | 2.4%       | -5.3%     |
| Average Relative Valuation Change | 3.1%       | -4.9%     |

**Note:** Cumulative Midcap Net Outperformance is the midcap relative performance net of the assumed structural premium (1.45% annualized). Relative Valuation is defined as the Mid/Top P/B ratio. \*Analysis has a December 1997 start due to availability of midcap valuation data. Sources: Bloomberg, FactSet and MFS calculations.

Given current valuation conditions, it may be a compelling time to invest in midcaps. Exhibit 6 indicates clearly that relative midcap valuations are near historic lows. It also indicates that any rebound in relative valuation levels is likely to have a dramatic effect on midcap relative performance. After 10 years of persistent cheapening in relative valuations, the price-to-book (P/B) of midcaps is around 60% of the P/B of Top, its lowest value in about two decades. And while extreme valuations can persist for some time, a reversal of this trend could provide a tailwind for relative midcap performance.

Market concentration in large-cap stocks, currently at very high levels, may also suggest an opportune entry point. Our previous analysis illustrates that the size premium tends to outperform during the diversification cycle that follows a concentration peak.<sup>5</sup> Moreover, the more diverse sector representation within the Mid index may provide an additional performance boost during a diversification cycle. Overall, a reversal in market concentration trends could provide an additional tailwind to midcap performance.

## Conclusion – Midcap Opportunity

Midcaps have historically provided a structural return advantage, offer greater diversification across companies and sectors and benefit from lower levels of attention from analysts. These attractive characteristics can enhance returns, improve risk management and allow for greater security selection opportunities. Additionally, we find that current relative valuation levels are attractive relative to history, with market concentration sitting at elevated levels. A normalization here may provide additional tailwinds for midcap outperformance. ▲

## Endnotes

- <sup>1</sup> July 1926 – December 2024. Calculated using the size factor from Ken French's website.
- <sup>2</sup> Sources: FactSet and MFS calculations
- <sup>3</sup> This time period is the longest available for the valuation data used.
- <sup>4</sup> Similar results can be found when looking at other valuation measures, such as price-to-sales.
- <sup>5</sup> "The Other Side of Market Concentration Peaks," July 2024.

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